



FEDERATION OF TAX ADMINISTRATORS

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FEDERATION OF TAX ADMINISTRATORS

AMERICA'S STATE TAX OFFICIALS

Multistate Tax Commission



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The Federation of Tax Administrators and the Multistate Tax Commission oppose H.R. 1956, the Business Activity Tax Simplification Act. As explained below, the bill represents an unwarranted federal intrusion into state affairs; it creates rampant tax-planning opportunities to avoid and evade tax; it will reduce state revenues substantially (\$3 billion per year by 2011 according to the Congressional Budget Office); and it will work to the detriment of small and in-state businesses that pay state taxes.

The bill protects tax-avoidance schemes. By prohibiting a state from taxing any entity that does not maintain any of the listed types of physical presence in the state, the bill provides any number of opportunities to structure corporate affiliates and transactions to avoid state taxes. For example, one of the more common such schemes is the use of intangible holding companies to shift income of retailers with many stores in each state to a low-or-no-tax state. The retailer's trademarks are moved to a holding company established in a low-or-no-tax state, and the affiliate with the stores then transfers its profits to the holding company in the form of royalty payments. This effectively transfers income earned in the states where the stores are located (by a company with a very substantial physical presence in those states) to another state that might not tax that income. To add insult to injury, the affiliate with the stores will likely deduct the royalty payments as a current expense.

Currently, this is considered somewhat risky tax planning because corporations do not know whether or not the courts will ratify the income shifting. (Several state courts have not.) There could be substantial penalties and interest facing a corporation that loses such a case. If H.R. 1956 becomes law, that risk will disappear; a state would be prohibited from taxing the holding company to which the income earned in the state was shifted, because the holding company would not have any of the bill's specifically enumerated types of physical presence in the state. Further, these shifting schemes would become not just standard, but required, tax planning due to the fiduciary duties corporate boards of directors owe to their shareholders. This is just one of any number of such planning opportunities the bill allows. Others would include conducting business in a state through related entities while avoiding the list of what the bills says constitutes a taxable presence in the state.

The bill favors big business over small. The planning opportunities presented by H.R. 1956 are not readily available to just any business; rather, the advantages offered by the bill are most likely not going to be available to small businesses. Those businesses will have to continue paying taxes their larger competitors will be able to avoid. While there is nothing in the bill that specifically limits its protections to larger businesses, in practical terms, larger businesses will have more opportunities available to them to engage in the tax-planning activities discussed above. For example, a corporation cannot simply establish an affiliate in a low-tax state and assign all of its income to that affiliate; if that were to happen, the original taxing state could disregard the second corporation as a sham. Instead, there must be at least the appearance of a business purpose for setting up that second corporation, and that appearance is more available to larger corporations that will be able to segregate various operations, for example, by having their trademarks put into another entity and then licensed back to the original operating entities. Mom-and-pop operations most likely don't have those options, and most likely don't have the resources to pay for the tax-planning services necessary to develop and implement them.

The bill favors out-of-state businesses over in-state businesses. H.R. 1956 would allow large corporations that can conduct business online to go into a state electronically, exploit the market in that state with all of the services it may offer and that may also be offered by in-state businesses, and not have to pay that state's corporate taxes, while the in-state businesses are stuck paying the taxes. For example, under this bill, a state would be prevented from taxing an online seller of computers and electronics that separately incorporates its warranty and repair functions as an independent contractor, so long as that independent contractor also contracts with another customer, which could be another affiliated company. The seller would be able to exploit the in-state market, including providing the support services that are essential to maintaining its market, without being taxable in the state, while in-state sellers would be subject to tax. Or, a bank that has the capacity to offer all of its services online would be able to provide those services to every citizen of a state from outside the state, without opening a branch in that state, and yet never have to pay any corporate taxes to that state. These are just two examples of large corporation that could leverage economies of scale to exploit a market in a state without being physically present there, while gaining the competitive advantage of not having to pay that state taxes, as the in-state companies that open offices and provide jobs to that state's citizens would have to do. That makes H.R. 1956 not only patently unfair, but also a strong deterrent to companies considering actually moving into the states, with buildings and jobs, where they conduct their business and derive their profits.

The timing of this bill contradicts other activity by Congress. As noted above, H.R. 1956 not only authorizes, but could compel what is now considered risky tax planning that makes use of a variety of means of sheltering income earned in a state. This directly contradicts the recent activity of Congress in eliminating a variety of tax-shelter activities for federal income tax purposes. It also contradicts Congress's consideration of bills that would expand the authority of states to require collection of sales and use taxes by interstate sellers; in that situation, Congress is considering undoing the current physical-presence requirement for purposes of the only taxes for which that standard is required, sales and use taxes. H.R. 1956 would impose a nexus standard narrower than physical presence on taxes for which the physical-presence standard is not now the law.

Also, by expanding the protections of Public Law 86-272 from solicitations of sales of tangible personal property to solicitations of sales of anything, the bill would be constraining the ability of states to tax sales activity involving products such as digital goods and services, at precisely the time when the national economy is evolving into one geared more toward exactly those types of non-tangible products – as is acknowledged by Congressional efforts to expand the authority of states to require collections of sales and use taxes on interstate sales.

The bill radically changes the state of the constitutional law. Some proponents of H.R. 1956 have indicated that the bill merely provides necessary, common-sense clarifications as to what constitutes a physical presence, and that such a bill is needed to clarify what they say is the current state of the law, i.e., that a state may only impose a business activity (BAT) tax on a business conducting interstate commerce when that business has a physical presence in the state. Such statements, however, are simply not true. Current law does not hold that a state may only impose a BAT on a business conducting interstate commerce when that business has a physical presence in the state. This has been made clear by the best source possible, the United States Supreme Court. In *Quill Corp. v. North Dakota*, the 1992 decision that affirmed that a physical presence is required to satisfy the “substantial nexus” standard for sales and use taxes, the Supreme Court specifically said (twice) that it had never applied the physical-presence standard to other taxes: “Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes ...”; and, “In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement ...” Therefore, it can be inferred that, since the rigorous physical-presence standard has clearly not been established by the Supreme Court as the nexus standard for BATs, the standard must be something less than physical presence, such as an economic presence. Also, since *Quill*, the vast majority of state appellate courts that have addressed the question of whether the physical-presence requirement of *Quill* applies outside of the context of sales and use taxes have ruled that it does not. Further, H.R. 1956 would negate U.S. Supreme Court decisions involving attributional nexus through independent contractors, such as *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, a 1987 decision upholding the imposition of Washington’s business and occupation tax based on the use of an in-state sales representative, characterized as an independent contractor.

The bill constitutes a substantial unfunded mandate on states. The Congressional Budget Office projects that if H.R. 1956 is enacted it will reduce state revenues by \$1 billion in the first year it is in effect. That total is projected to triple to over \$3 billion per year by 2011 as businesses restructure their operations to take advantage of the planning opportunities afforded by the bill. This is the single largest tax preemption ever estimated by the Congressional Budget Office.

This interference in state sovereignty by Congress has not been justified. H.R. 1956 represents a break from existing U.S. Supreme Court precedent. By allowing all sorts of tax planning to avoid and evade taxes, will cost the states billions of dollars. Given that the power to tax has always been recognized, by courts and Congress alike, as a core

function of state sovereignty, what case has been made, what evidence provided, to justify such a massive preemption of the states' authority to tax? What problems, what crises, have been offered as a rationale for this bill? None of the proponents of H.R. 1956, or its predecessor H.R. 3220 in the 108th Congress, have ever stated publicly that it was important to allow large, multistate businesses to be able to shift their income from the states in which it is earned to a holding company in a low-tax state, or that it was essential to their survival that they be able to avoid state taxes simply by separately incorporating segments of their businesses. The only justifications for these types of bills have been related to companies who have relatively small presences in states. For example, in their announcement of the introduction of H.R. 1956, Reps. Goodlatte and Boucher spoke of "countless examples of aggressive state actions and positions against out-of-state companies," such as states imposing taxes on businesses whose trucks pass through a state only a handful of times in a year, or who only maintain a web site on a server in the state, or who merely register to do business or list a telephone number in the state.

If these instances of small or de minimis presences in a state constitute the entire premise for bills such as H.R. 1956, why not draft a bill that addresses those situations? Most states already have de minimis standards for imposing their BATs, so it would simply be a matter of reviewing them to see which ones Congress agreed with, or coming up with new ones. But none of those de minimis situations can come close to justifying a bill that allows large, multistate business to shift income and otherwise avoid state taxes that in-state companies are paying simply by arranging paper reorganizations of their operations. The only justifications for that are legalistic, form-over-substance claims that the corporation should be rewarded for jumping through all the hoops required to establish separate corporate forms that aren't shams.

The proponents of this bill attract people to their cause with talk of small presences in states resulting in onerous corporate tax liabilities, but then actually sell a measure that allows large, multistate businesses with large dollar amounts of business, and sometimes even many stores and employees, in the state to avoid paying the corporate taxes that are being paid by the in-state businesses of that state. If the proponents are truly concerned about the matter of small presences in a state resulting in onerous tax liabilities – a cause that has merely been asserted, but never proven – the states would be willing to work with Congress and the private sector to arrive at a proportionate response. H.R. 1956 is not a proportionate response.

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